

Message Text

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DEPARTMENT TREASURY
WHITE HOUSE WASHDC
INFO AMEMBASSY BRUSSELS
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USEEC AND USOECD ALSO FOR EMBASSIES
WHITE HOUSE FOR OWEN

E.O. 11652: N/A
TAGS: ECON EFIN GW
SUBJECT: TAX DEBATE HEATS UP PRE-SUMMIT
GERMAN POLITICAL SCENE

1. SUMMARY -- ISSUE OF TAX REDUCTION AND REFORM HAS
GOTTEN VIRTUALLY ALL SHADES OF GERMAN POLITICAL
SPECTRUM INTO VIGOROUS POLITICAL DEBATE. FDP'S EFFORT
TO PRESSURE SPD ASSENT TO SIZEABLE 1979 TAX REDUCTIONS,
INCLUDING ECONOMICS MINISTER LAMBSDORFF'S WASHINGTON
REMARKS ABOUT A DM 12 BILLION TAX CUT, HAVE BROUGHT
REMINDERS FROM SPD AND GOVERNMENT SPOKESMEN THAT NO
DECISION ON THE BUDGET HAS OR WILL BE MADE UNTIL AFTER
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THE ECONOMIC SUMMIT. IN THE MEANTIME, CHANCELLOR
SCHMIDT IS CONCERNED TO MAINTAIN AS MUCH BARGAINING POWER
AS HE CAN AT THE BONN ECONOMIC SUMMIT. OPPOSITION
GROUP CSU CHAIRMAN STRAUSS, CDU SPOKESMEN, AND VARIOUS
ADVOCATES OF TAX REFORM HAVE INTENSIFIED THEIR EFFORTS
TO PREEMPT THIS POPULAR POLITICAL ISSUE AND EIGHT OF
ELEVEN LAENDER FINANCE MINISTERS HAVE ENDORSED SPEEDY

TAX REDUCTIONS. END SUMMARY.

2. FOR MONTHS A THINLY DISGUISED STRUGGLE HAS BEEN UNDERWAY BETWEEN ECONOMICS MINISTER LAMBSDORFF (FDP) AND FINANCE MINISTER MATTHOEFER (SPD) OVER THE ISSUE OF WHETHER TAX OR EXPENDITURE POLICY WAS THE MORE APPROPRIATE TOOL TO STIMULATE THE SLUGGISH GERMAN ECONOMY. UP UNTIL RECENTLY, THE CONFLICT COULD BE MUTED AS BOTH THEY AND THEIR PARTIES TOOK THE PUBLIC STANCE THAT NO FISCAL STIMULATION WAS NEEDED BEFORE FISCAL MEASURES

TAKEN AT THE END OF 1977 HAD HAD A CHANCE TO TAKE HOLD AND THAT IN ANY EVENT PUBLIC DISCUSSION OF ADDITIONAL ECONOMIC STIMULATION CAUSED BUSINESS AND CONSUMERS TO DEFER SPENDING DECISIONS AND SHOULD THEREFORE BE AVOIDED.

3. RECENT DISASTROUS DEFEATS IN LAENDER ELECTIONS REMOVED MOST OF THE FDP'S INCLINATIONS TO SUBORDINATE ITS VIEWS ON THE THORNY ISSUES OF TAX CUTS AND INSTEAD HAVE PUT A PREMIUM ON ITS EFFORTS TO SHOW WHERE IT DIFFERED FROM THE SPD. IN MID-JUNE THE FDP UNVEILED A TAX AND EXPENDITURE PACKAGE FOR THE 1979 BUDGET WHICH HAS BEEN VARIOUSLY ESTIMATED AS INVOLVING DM 20-30 LIMITED OFFICIAL USE

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BILLION IN BUDGET COSTS. THE MOST IMPORTANT ELEMENT IN THE FDP TAX PACKAGE IS A MODIFICATION OF THE PERSONAL INCOME TAX SYSTEM WHICH WOULD MAKE THE STRUCTURE LESS PROGRESSIVE FOR MIDDLE INCOME GROUPS (COST EST. AT BETWEEN DM 14 BILLION AND DM 20 BILLION). SHORTLY THEREAFTER, THE COUNCIL OF ECONOMIC EXPERTS ISSUED A SPECIAL REPORT ADVOCATING TAX CHANGES, INCLUDING LOWER BUSINESS TAXES, WHICH WERE SUBSEQUENTLY ENDORSED VIRTUALLY IN TOTO BY THE FDP. A LAMBSDORFF DEFENSE OF THE COUNCIL FOLLOWING SPD CRITICISMS OF THE DECISION TO MAKE A SPECIAL REPORT ON THE ECONOMIC SITUATION REINFORCED TENSIONS BETWEEN THE SPD AND THE FDP OVER ECONOMIC POLICY.

4. FORCED ON THE DEFENSIVE, MATTHOEFER, VARIOUS SPD SPOKESMEN AND THE CHANCELLOR HAVE ARGUED THAT FOR TECHNICAL REASONS A REVISION OF ITS INCOME TAX SCHEDULE CANNOT BE INTRODUCED UNTIL JANUARY 1, 1980. IN ADDITION, THEY HAVE ARGUED THAT INCREASED PUBLIC SECTOR OUTLAYS WOULD HAVE MORE BANG FOR THE MARK THAN WOULD TAX FAVORS TO BUSINESS WHICH HAS DONE LITTLE WITH THOSE IT HAS GOTTEN IN RECENT YEARS. MATTHOEFER IN PARTICULAR HAS

TAKEN THE PUBLIC POSITION THAT THERE IS NO ROOM IN THE 1979 BUDGET FOR LARGE TAX CUTS AND THAT SUCH ADDITIONAL MONEY AS THERE MAY BE SHOULD BE PUT INTO PUBLIC INVESTMENT, PARTICULARLY THE RESEARCH AND DEVELOPMENT OF NEW TECHNOLOGIES. (ON THE QUESTION OF HOW MUCH THE PUBLIC SECTOR BUDGET SHOULD EXPAND IN 1979, HE HAS WAFFLED

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BETWEEN SLIGHTLY MORE THAN SIX PERCENT UP TO NINE PERCENT). MATTHOEFER AND OTHER SPD SPOKESMEN ADMIT, HOWEVER, THAT TAX REVENUES HAVE BECOME TOO DEPENDENT ON DIRECT TAXES AND THAT THE FORMER RATIO BETWEEN DIRECT AND INDIRECT TAXES SHOULD BE RESTORED EVENTUALLY.

5. CURRENTLY DIRECT TAXES ACCOUNT FOR ABOUT TWO-THIRDS OF ALL PUBLIC SECTOR TAX REVENUES WHEREAS UNTIL ONLY SIX OR SEVEN YEARS AGO THEY ACCOUNTED FOR ONLY ABOUT ONE-HALF. BOTH INFLATION AND HIGHER REAL INCOMES HAVE HELPED TO RAISE MOST GERMAN TAXPAYERS INTO HIGHER PERSONAL INCOME TAX BRACKETS. THE PINCH OF HIGHER PERSONAL INCOME TAXES HAS BEEN FELT MOST ACUTELY BY MIDDLE INCOME

RECIPIENTS. AT AN INCOME OF DM 16,000 (SINGLE) OR DM 32,000 (MARRIED), TAXPAYERS MOVE FROM A FLAT 22 PERCENT TAX RATE ON INCOME TO A MARGINAL TAX RATE OF LIMITED OFFICIAL USE

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30.8 PERCENT WHICH RISES PROGRESSIVELY ON ANY ADDITIONAL INCOME UP TO A TOP MARGINAL RATE OF 56 PERCENT. IN ADDITION, PAYROLL DEDUCTIONS TO FINANCE THE SOCIAL INSURANCE SYSTEM HAVE HAD TO BE INCREASED TO PAY FOR MORE LIBERAL BENEFITS. THESE DEVELOPMENTS HAVE UNDOUBTEDLY MADE THE TAX SYSTEM MORE PROGRESSIVE. ARGUMENTS ABOUT THE DISINCENTIVE EFFECTS, WHICH SUCH STEEP TAX PROGRESSION ALLEGEDLY HAS, ARE BEGINNING TO MAKE A GREATER IMPRESSION ON TAXPAYERS IN THESE BRACKETS, WHICH NOW INCLUDE THE BULK, THAN DO ARGUMENTS ABOUT SOCIAL EQUITY. DISENCHANTMENT WITH THE TAX SYSTEM IS ONLY EXACERBATED BY THE EXISTENCE OF A SIZABLE GROUP OF INCOME RECIPIENTS (INCLUDING THOSE WITH INCOMES FROM "ILLCIT" WORK) WHO PAY NO INCOME OR SOCIAL INSURANCE TAXES.

6. TAXPAYER DISILLUSIONMENT WITH THE SYSTEM HAS MAGNIFIED WITH ITS GROWING COMPLEXITY. GOVERNMENT EFFORTS TO PROMOTE ONE KIND OF ACTIVITY OR ANOTHER HAVE GIVEN RISE TO AN ALMOST ENDLESS ARRAY OF REGULATIONS QUITE BEYOND THE POWERS OF THE AVERAGE CITIZEN TO GRASP. PUBLIC DISSATISFACTION WITH THIS STATE OF AFFAIRS IS INDICATED BY RECENT POLLS WHICH SHOW MANY VOTERS FAVORING THE EXISTENCE OF A TAX PARTY (EVEN IF THEY ARE RELUCTANT TO VOTE FOR SUCH A PARTY). A SPD MEMBER AND HEAD OF THE ASSOCIATION OF TAX OFFICIALS, HERR FREDERSDORFF, HAS RECENTLY DROPPED HINTS THAT HE MIGHT TRY TO FILL THE BILL AND SUGGESTIONS HAVE BEEN MADE FOR FUSING THE "GRUNE LISTE" (ENVIRONMENTAL GROUP) WITH THE TAX REVOLT MOVEMENT. ALTHOUGH THE FORMATION OF A COALITION BETWEEN THESE TWO GROUPS IS AS YET PROBLEMATIC, SUCH AN ELECTORAL COMBINATION MIGHT BE ABLE TO TAKE SUFFICIENT VOTES FROM THE FDP LIMITED OFFICIAL USE

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IN THE OCTOBER HESSE ELECTIONS TO REMOVE IT FROM THE LAND PARLIAMENT.

7. THE MOST RADICAL PROPOSAL SO FAR HAS BEEN THAT OF RHEINLAND/PFALZ FINANCE MINISTER GADDUM (CDU). HE WOULD ELIMINATE ALL PERSONAL INCOME TAX DEDUCTIONS

EXCEPT FOR THE BASIC DEDUCTION (WHICH HE WOULD RAISE TO DM 4,000 FOR EACH FAMILY MEMBER) AND REPLACE TAX INCENTIVES WITH DIRECT SUBSIDIES. IN HIS PROPOSAL, THE STARTING RATE (NOW 22 PERCENT) AND THE NUMBER OF INCOME BRACKETS WOULD BE REDUCED. IN A JULY 3 INTERVIEW WITH HANDELSBLATT (BUSINESS DAILY) HE DOES HOWEVER WAVER A BIT ON THE QUESTION OF SPECIAL TAX TREATMENT FOR FARMERS (A BASTION OF THE CDU). MANY OF HIS OWN PARTY ARE AS COOL TO THE IDEA OF ELIMINATING TAX INCENTIVES AS IS THE SPD. SUCH INCENTIVES PLAY IMPORTANT ROLE IN ENCOURAGING BUSINESS INVESTMENT AS WELL AS SERVING AS AN INSTRUMENT OF SOCIAL POLICY.

8. PROBABLY MORE IMPORTANTLY, FRANZ-JOSEF STRAUSS (CSU), HAS ENTERED THE DEBATE WITH AN ALACRITY WHICH BETRAYS THE SENSITIVE NOSE OF A POLITICIAN KEEN TO AN ISSUE WHOSE DAY HAS COME. STRAUSS CLAIMS, ON THE ONE HAND, THAT THE CHAMPIONS OF A SIMPLER SYSTEM AND LOWER TAXES ARE SAYING NOW WHAT HE HAS BEEN SAYING ALL ALONG. ON THE OTHER HAND, HE ATTACKS THE GOVERNMENT FOR RUNNING BUDGETARY DEFICITS. BEING IN THE OPPOSITION, HE DOES NOT HAVE TO SHOW HOW TAXES AND BUDGET DEFICITS ARE TO BE LOWERED SIMULTANEOUSLY. BY ENDORSING A PROGRAM PRACTICALLY IDENTICAL WITH THAT OF THE FDP, HE IS CALLING ON THE FDP TO FISH OR CUT BAIT, EITHER JOINING WITH THE OPPOSITION IN PUSHING THE TAX REDUCTION THROUGH OR DROPPING IT AS THE ISSUE OF THE FDP.

9. PRESSURE FOR PARLIAMENTARY ACTION ON TAXES

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HAS BEEN STRENGTHENED BY A WEEKEND ENDORSEMENT OF SPEEDY TAX CUTS BY EIGHT OF THE ELEVEN LAENDER FINANCE MINISTERS. ACCORDING TO A SURVEY OF THE WEEKLY "WELT AM SONNTAG" THE LAENDER FINANCE MINISTERS ATTACH HIGHEST PRIORITY TO REDUCTIONS OF PAYROLL TAXES AND INCOME TAXES. THEY ALSO EXPRESSED STRONG SUPPORT FOR EASING GOVERNMENT REGULATIONS WHICH RESTRAIN INVESTMENT.

10. CHANCELLOR SCHMIDT SEEMS FOR THE MOMENT WILLING TO LET THE CONTROVERSY BETWEEN FDP AND SPD SIMMER, PARTICULARLY AS IT INCREASES HIS NEGOTIATING FLEXIBILITY AT THE SUMMIT. FDP AND SPD LEADERS, MOREOVER, SEE THAT IT IS IN THEIR OWN INTERESTS NOT TO ALLOW THEIR DIFFERENCE OVER TAXES TO GET OUT OF HAND. THE FDP RECENTLY VOTED WITH THE GOVERNMENT AGAINST AN OPPOSITION-SPONSORED TAX PROPOSAL EVEN THOUGH IT WAS MUCH ALONG THE LINES OF THE LIMITED OFFICIAL USE

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FDP PROPOSAL. THE FDP IS COMMITTED TO A COALITION WITH THE SPD IN HESSE AND TOO DEEP A SPLIT WITH THE SPD WOULD LIKELY DAMAGE THEIR ELECTORAL PROSPECTS THERE. ACCORDING TO THE PRESS, LAMBSDORFF ON JULY 4 MADE SOME PLACATORY SOUNDS TO THE SPD ABOUT HIS DM 12 BILLION TAX PROPOSAL. WILLI BRANDT, OTHER SPD AND FDP LEADERS HAVE BEEN AT PAINS DURING THE PAST WEEK TO EMPHASIZE THAT THE COALITION IS NOT GOING TO FALL APART ON THIS ISSUE. A COMPROMISE INVOLVING CONCESSIONS ON TAXES AND ADDITIONAL EXPENDITURES SEEMS TO BE IN THE WIND.
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